Session 4 (Day 2 Afternoon)
Revenue Raising and Municipal Credit for Infrastructure Investment

Session Overview

Providing strong and reliable infrastructure networks is one of the most important contributions the public sector makes to improve the investment environment. Communities in the E&E region working to secure sufficient revenues for public improvements face numerous challenges:

- Local governments continue to rely on central government transfers for infrastructure improvements; such transfers are often unpredictable and insufficient.
- Many public services, such as roads and education facilities, do not generate revenue.
- Local governments have limited ability to set tariffs or levy property taxes for capital improvement purposes.

This session looks at the difficulty of raising revenues for public infrastructure from two perspectives. From local governments' perspective, the session explores what revenues can be raised given the current authority they have vis-à-vis the central government. In addition, the session looks at the problem from the perspective of long-term fiscal and administrative legislative changes that would be required for local governments to be financially self-sufficient. Revenue-raising schemes that reflect a wide spectrum of fiscal decentralization are presented so that a varied audience can participate in the course.

Revenue sources for public infrastructure are generally derived from taxes, fees, tariffs, and government transfers—all of which are ultimately paid for by individual residents or businesses (either through a local revenue generation scheme or a central government tax that is transferred back to the local government). As more and more of these revenues are generated locally due to fiscal decentralization in the region, the local government should carefully consider the mix of revenue sources so that one user group does not pay an excessive amount for the service and so that the pricing (the cost of services) for business is competitive in comparison to other communities. Until the devolution of authority stabilizes in the E&E region, central government transfers will be the primary (if not the only) source of revenue. This fact, however, should not preclude local governments from instituting practices needed for self-sustaining and locally financed public systems.

The presentations in this session examine factors that affect the generation of private and public sector revenues for public infrastructure. Specific attention is given to financial and project management practices, the linkage between sustainable revenues and investor confidence, and the added value of proper capital improvement planning as it relates to sustainable revenues.

Session Objectives

- To explore financial institutions' lending criteria for local governments and public utility authorities.
- To explain the relationship between sustainable revenues and financing for capital investment, including debt financing.
- To identify sustainable revenue strategies within the parameters of local government fiscal authority.
- To identify factors that may impede revenue generation and to suggest approaches that may mitigate common obstacles, including increasing the fiscal autonomy of local government.

Trainer's Notes

1 hour Presentation: **Raising Revenues for Public Infrastructure Investment**

This presentation is based on the talking points and overheads that follow the presentation notes. You will need to refer to these to prepare this presentation.

10 min

1. Begin by explaining that the topic under discussion is raising revenues for public infrastructure. Ask participants to think about how infrastructure improvement relates to economic development. Why are such improvements necessary? What types of infrastructure improvements are needed to bolster economic development? List their responses on the flip chart.

5 min

2. When you have generated a list, turn attention to why these improvements are needed to bolster economic development. Explain that the public infrastructure and services on the list (which should include water, wastewater, urban transportation, solid waste disposal, etc.) are factors that influence business decisions of private companies wishing to relocate or expand their businesses. Follow the talking points to discuss the three reasons that capital investment is needed. Emphasize the link between the need to pay the capital back and the revenue stream of the local government. Use local examples to illustrate key points.

10 min

3. Discuss the two categories of services: revenue generating and non-revenue generating. Ask participants to give examples of each. List these on a flip chart. When you have developed a list, explain that wherever possible, local governments should allocate budget funds to the non-revenue-generating entities for investment, while revenue-generating entities should be encouraged to cover full costs. Follow the talking points and discuss the elements that affect the pricing of public services; revenue-generating schemes such as fee for services, taxes and transfers; and the authority local government has or needs to raise revenues for public services.

10 min

4. Then, turn attention to financing capital improvements, emphasizing the linkage between operation/maintenance costs and capital costs. Give particular attention to how financing capital improvements relates to overall revenue generation and sustainability. Follow the talking points and include in the discussion the following points:

   - Financial solvency
   - Operating budget (operation and maintenance of systems)

- Capital improvement planning
- Pricing and revenue collection
- Capital improvement expenditures and debt financing
- Taxation authority and legal framework.

As you discuss these issues, be sure to define and give examples of each. Use local examples whenever possible.

10 min 5. To continue, ask participants what people or groups of people are affected by pricing decisions. Engage them in a discussion of this issue, making sure to touch on all the groups outlined in the talking points. Then, ask participants to think about how these people affect pricing decisions and go over the questions that often come up in reviewing costs, using the talking points.

10 min 6. Conclude by discussing the ramifications of this information for local governments. Emphasize in particular the steps that local governments should take before they can raise revenues for investment. As you show the corresponding overhead, ask participants if there are any additional recommendations they would add to this list.

5 min 7. Conclude with a summary of the discussion. Remind participants that after the break they will return to engage in small-group work.

2½ hours Group Assignment: Evaluating Revenue-Generating Options

5 min 1. Break participants into small groups of four to six participants. Consider breaking into mixed groups so that different perspectives are represented in the small-group discussions. Distribute the handout, “Evaluating Revenue-Generating Options,” and flip chart paper on which they will post their answers.

10 min 2. Introduce the activity by explaining that the purpose is to determine how national and local administrative, political, and economic factors influence the viability of public and private revenue sources. Instruct groups to identify an infrastructure problem in their own country, which they will then present to all participants. The small group’s presentation should (1) state the problem, (2) describe the revenue-generating authority and capacity of the community to fund infrastructure improvements or repairs, and (3) list the revenue sources that are being considered and why. Inform participants that the concept of “capacity” includes the government’s ability to raise revenues from citizens and businesses through taxes and fees, to provide leadership for citizens and financial institutions, and to manage the financial and operating systems of services provided. Suggest that participants may want to use the pre-course homework information and information from the presentations to develop their problem statements. Give participants a few minutes to read the handout and ask any questions they have about the activity.

45 min 3. Allow groups 45 minutes to prepare their presentations. Give a reminder when groups have only 10 minutes left to complete their work. *(A break may be built into the end of this activity.)*

75 min 4. Reconvene the group, and ask each small group to make a report on its findings. Before the first group begins, explain that you would like to keep each presentation to 15 minutes. Such presentations often run over the desired time limit; try to keep the discussion moving. After each group's presentation, critique the group's findings, asking questions about political stability and leadership needed to sustain financial practices. Consider the elected leadership's commitment to practicing fiscal discipline in order to cover existing obligations. What experience do key department heads have in the area of corporate management? How secure is the revenue stream for the repayment of loans? What type of collateral would be offered? What administrative changes would be needed to ensure the maintenance of infrastructure? Remind the participants that the issue of administrative capacity is larger than maintenance of infrastructure. It includes administrative capacity to carry out project preparation, financial analyses, negotiations with lenders, loan monitoring, and general management of service provision. Encourage participants from other groups to ask questions of the group as well. *(The time needed will vary depending on the number of groups.)*

15 min 5. When all groups have had a chance to report, ask participants what they learned from the exercise. What was the most difficult part of developing the plan? Why? What elements did all of the presentations have in common? What elements would participants now add to their plans based on what others came up with, as well as the trainer's questions? The discussion should include the following key points:

- ➢ The political and administrative structure has a profound impact on demonstrating the financial feasibility of infrastructure projects.
- ➢ Infrastructure financing requires that there be a corresponding relationship between the cost of service delivery and the revenues generated by the service.
- ➢ Eliminating or reducing utility subsidies encourages sound use of resources and fair distribution of costs.
- ➢ Credit institutions carefully review an organization's management of finances, operations, and maintenance of public services; these aspects are thus key to securing financing for both the local government and the utility company.

Talking Points: **Raising Revenues for Investment**

General public infrastructure and services such as water, wastewater, urban transport, and solid waste disposal require capital investment. Public services throughout the E&E region are provided principally through budgetary enterprises or through private companies. Regardless of who operates the system and manages the service, and regardless of who owns the capital assets, public services require capital investment for three reasons:

- To replace facilities that have reached the end of their useful life
- To improve facilities serving existing users (perhaps to comply with new regulations)
- To expand facilities to serve new users.

Sources of capital may vary, but one thing is certain—the capital has to be paid back. This results in the need for local governments to look carefully at raising additional revenues to cover new investment.

Revenue-Generating Strategies and Pricing of Public Utilities

Optimal revenues result from setting "good pricing systems" that will raise the revenues needed to cover new investments for the provision of services and infrastructure, such as roads, hospitals, and schools. In pricing public utilities, local governments must consider two sides of the equation: revenues and expenditures. Revenue budgets may reflect different sources of funds for the operation, maintenance, and improvements of a system. Local governments in the E&E region typically use some mix of fees for services (user fees), proceeds from general or special taxes, and transfers from the central government. Local governments in different countries have varying degrees of authority related to raising revenues through each of these sources. Expenditure budgets must cover operations, maintenance, and debt retirement.

Pricing Systems for Revenue-Generating Entities

Services in most local governments can be divided into two categories: revenue-generating and non-revenue-generating. Where possible local governments should allocate budget funds to the non-revenue-generating services (such as storm drainage) for investment. Revenue-generating entities should be encouraged to cover the full cost of service delivery.

A good pricing system arrives at prices that cover the cost of providing the public services in question. There are practical reasons for this:

- The revenue stream from fees and charges is an identifiable and pledgeable revenue stream that can provide a sound basis for financing capital investments through borrowing. Unless the price of the service covers the full cost of providing that service, financing of investments will require the support of other funds from the budget or subsidies.

- Pricing a commodity at its true production cost tends to ensure that society as a whole will use resources efficiently.

The pricing system should cover both operating and maintenance costs, and the system should allow for recovery of capital investment costs. The three general types of investment costs—replacement costs, improvement costs, and expansion costs—are described below:

Replacement costs: As a system is used, it deteriorates. In a water supply network, for example, a portion of the facility's useful life expires with every bit of water that is pumped, treated, and consumed. Thus, a good pricing system would set prices that include the amortization of the facility as a charge to current users. Similarly, the price of using a solid waste landfill should include the eventual cost of closing the facility and restoring it to "green" condition.

Improvement costs: One would expect current consumers who benefit from improved water quality to pay for these charges as part of their user fees. Thus, a good pricing system should include improvement costs.

Expansion costs: A good pricing system should take into account the costs of expanding facilities to serve new users. These costs include not only the cost of extending lines to serve new areas, but also the cost of the portion of other capital facilities that will be made available for use in the new areas.

One way to derive these capital investment costs from users of the system is by amortizing the price of a capital asset over a period of years (according to the expected useful life of the asset) and including the amortized cost in the base rate. Amortization schedules developed for the pricing system need to be the same as those used for tax or accounting purposes.

In addition to the above costs, the pricing structure must take into account the financing cost. It costs money to borrow. In addition to repaying the principal, the borrower must pay interest and service fees. Like the capital itself, the costs of borrowing should be borne by the people who benefit; that is, the users of the system.

A good pricing system should provide incentives to meet policy objectives, which may include such factors as service quality, consistency of service, environmental protection, health, safety protection, timely response to customer service interruptions and other maintenance issues, and prompt and adequate response to customer complaints.

Other Revenue Sources and Uses

The optimal revenues for public services are those generated through tariffs or user fees, such as water fees. Not all public services generate own-source revenues, however. Therefore, local governments must use general taxes or central government transfers. Revenues for new or improved road systems, for example, usually are generated through a tax levy. In addition, local governments sometimes subsidize the cost of providing a revenue-generating service so that a particular user group is not overburdened by excessive fees (such as heating for low-income citizens).

Taxes

In the E&E region, the authority to raise revenues at the local government level is limited. Each country and local government must review relevant legislation in order to determine what authority it has. In the long term, if they are to have sufficient revenues for capital investments, local governments will need to have fiscal autonomy and revenue-generating authority.

In reviewing what authority it has, the local government should give consideration to the following types of taxes—each of which can be used to cover the operating, maintenance, and capital costs of public services:

- Special revenue authorities (such as those used for toll roads in Hungary)
- Land and building taxes (property taxes)
- Dedicated excise or value-added tax transfers from the central government.

Transfers

The major source of general revenues in most E&E countries is transfers from the central government. In addition, capital improvements have been financed by special central funds. As decentralization of authority takes hold, the amount of these special transfers will decrease.

Revenues and Creditworthiness

E&E countries are gradually moving toward public and private credit markets for the purpose of funding capital improvements. Critical to success in shifting to this revenue source is the ability of the local government to demonstrate that it is a good credit risk. There are two important variables in the credit equation: the ability to sustain the revenue flow and the ability to manage the financial, operating, and capital improvement program. A poorly managed public service jeopardizes the revenue flow because the collection of fees or taxes becomes extremely difficult. Factors that private and public lending institutions look for when considering loaning money include:[1]

- Debt policies and position, including authority to incur debt and recent debt issues by local governments
- Financial operations and fiscal policies for the past five years, as well as current budget
- The central government's relationship with local subdivisions and changes to revenue-sharing and tax collection policies and procedures
- Economic profile of community and development plans
- Financial control and monitoring systems of the local government
- Comprehensive annual financial reports
- Public service management plans and operating procedures.

Participatory Decision Making

A tremendous number of people and institutions are affected by pricing decisions, including:

- Public service providers (private companies or budgetary enterprises)
- Citizens of all income levels
- Nongovernmental organizations
- Businesses in manufacturing and service industries
- Public-sector users, such as parks, hospitals, and schools.

Because so many parties are affected by fees and charges for public services, the ideal system affords all parties an opportunity to participate in the process by which rates and service standards are set. One way to achieve this is through public notice and open hearings, at which any interested parties can present evidence and policy arguments. A participatory mechanism offers the best chance for resolving differing priorities.

Regardless of how they are decided, user fees, the information on which they are based, and the process by which they are decided should be open to the public. This is necessary for participation by affected parties to be productive.

[1] This list is a compilation from sources including Fitch International, Dr. Sylvester Murray, Cleveland State University, and the World Bank.

Clear Guidelines

An ideal system should also include clear guidelines about the types of costs that can be included in the rate base (both what is and what is not allowed) and how costs are allocated to different functions and to different classes of customers. In the setting of prices, many challenging issues must be resolved. Here are some questions that come up in reviewing costs:

- Who should bear costs incurred for facilities not yet generating productive capacity, such as interest during construction, progress payments to the contractor, or land and resource acquisition costs?
- Should planning costs, such as costs for master plans, feasibility studies and environmental studies, be included in the price?
- When are advertising costs allowable as public education, and when should they be disallowed as commercial promotion?
- How should operating and capital costs be allocated to different classes of customers (bulk versus retail users)?
- How should interest and debt issuance costs be allocated to different classes of customers, especially present versus future customers?
- How should the reasonableness of rents, wages, consulting fees, travel, and other expenses be determined?
- What depreciation rules should apply? Should they be the same as the depreciation rules for tax purposes, or different?

In addition, local governments may wish to establish guidelines about allowable returns (or profits) and how they should be calculated. Such rules or guidelines could be developed by a regulatory body (if one exists), a central government agency, individual local governments, industry associations, a task force or committee, or some other process.

If local governments become more autonomous, their revenue-generating authority and responsibility should also increase. Ideally, local governments should be able to independently issue and secure debt. To do this, they must have authority to:

- Establish user fees and tax rates
- Pledge or dedicate the revenue source to the repayment of debt (capital and interest)
- Enter into contracts

- Own the public asset (i.e., sewer and water treatment plants and collection/distribution systems)

- Pledge the asset as collateral (for certain types of revenue mortgage bonds).

Steps That Local Government Must Take

Before revenues can be raised for investment, local governments should:

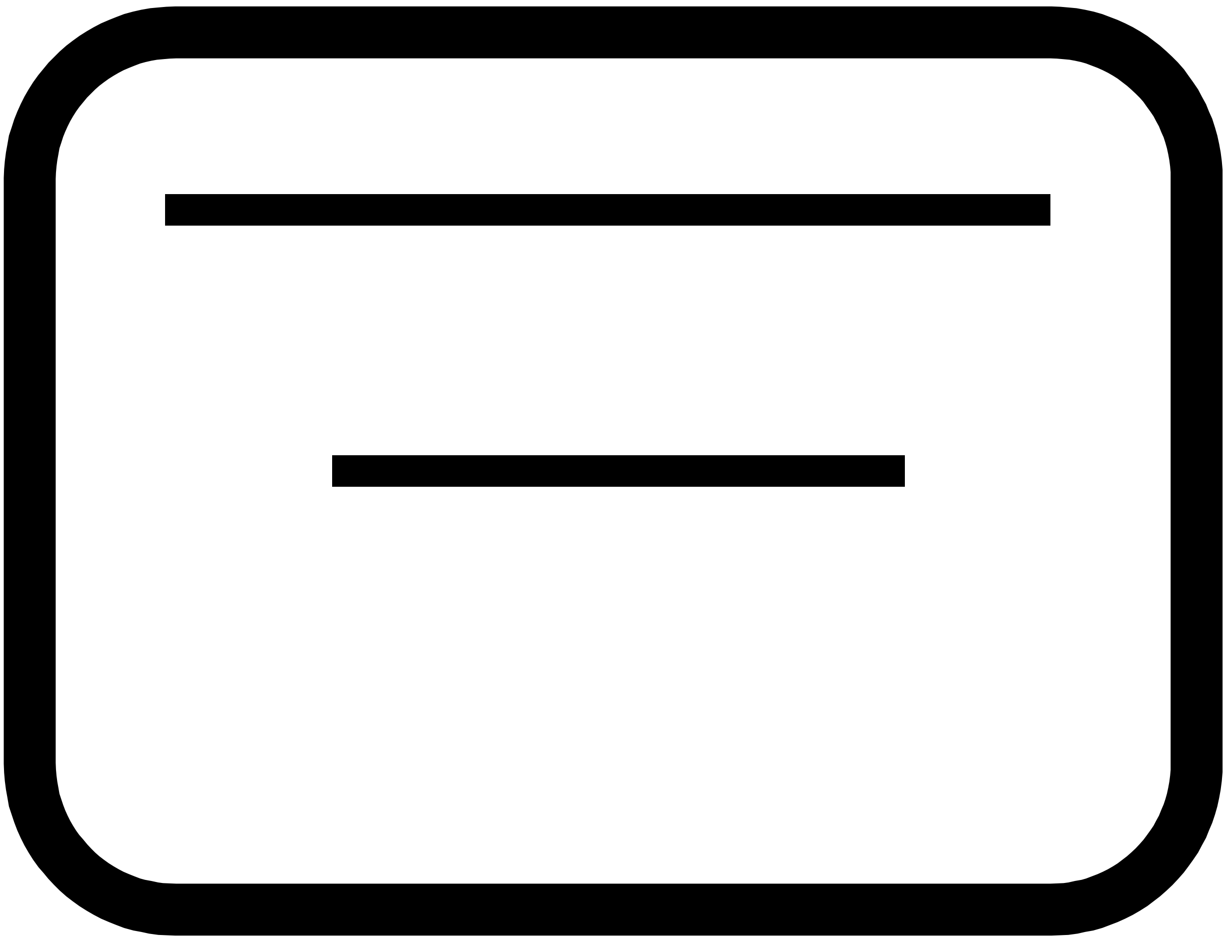
1. Set clear strategies on how both revenue-generating and non-revenue-generating entities should be allowed to set prices to enable investments to implemented.

2. Increase the capacity of human capital of the service organizations to better manage, operate, and develop the services they provide. Implementing good pricing systems requires good professionals who use the system to maximum advantage

3. Develop good project proposals to attract finance. One of the major weaknesses in E&E has been the lack of capacity in the local consultancy market to develop project proposals of sufficient standard to attract finance. Local governments must hire high-caliber consultants to develop project proposals.

4. Implement good pricing systems that are transparent and inclusive of the community.

Overheads



Why Raise Revenues?

- To invest capital in public infrastructure and services, which is necessary to replace facilities that have reached the end of their useful life, improve facilities serving existing users, and expand facilities to serve new users

- To pay back the capital

Setting Good Pricing Systems

- Results in identifiable and pledgeable revenue streams, which can provide a sound basis for financing capital investments
- Ensures that society as a whole will use resources efficiently

What Should a Good Pricing System Cover?

- Operating and maintenance costs
- Capital costs for replacement
- Capital costs for improvement of the facility
- Capital costs for expansion of the facility
- Financing costs

Service Standards

A good pricing system should provide incentives to meet policy objectives about service standards, including:

- Service quality
- Consistency of service
- Environmental protection
- Health
- Safety protection
- Timely response to customer service interruptions and other maintenance issues
- Prompt and adequate response to customer complaints

Guiding Principles for Revenue-Generating Strategies

- New revenues should not unfairly burden those least able to pay
- Where possible, the use of the revenues should correspond to the revenue-generating base (e.g., water tariffs pay for operation, maintenance, and capital costs of the water distribution system)
- Subsidies for services should only be used when a public purpose is realized (e.g., increased access to employment)

Characteristics of Revenue-Generating Tax Schemes

Special Revenue Authorities:	Revenue base corresponds to the service users
	Revenue flow is dedicated to operation, maintenance, and debt retirement of services
	Scheme is attractive to lenders
General Property Tax:	Revenue for non-revenue-generating services
	Can be structured so the value of the revenue base increases with increased value of property
	Limited use in E&E region
Excise Tax:	Tax that can be dedicated for a specific use
	Raises revenues from non-residents (e.g., hotel room tax)
	Generates revenues from the added value of a consumable product

Financial Lender Criteria

Intergovernmental Relations:	sustainable transfers, tax authority, administrative authority, and borrowing regulations
Administrative Systems:	management structure and labor relations
Economic Conditions:	employment base, changes in economic indicators, resource availability, and a profile of citizens' social and economic capacity
Fiscal Performance:	financial management systems, tariff and tax burden, and capital plans
Financial Position:	existing debt, existing assets and liabilities, and accounting practices

Participatory Decision Making

Because so many parties are affected by fees and charges for services, a participatory mechanism for setting rates and service standards offers the best chance for resolving differing priorities.

Those affected by pricing decisions include:

- Public service providers (private companies or budgetary enterprises)
- Citizens of all income levels
- Nongovernmental organizations
- Businesses in manufacturing and service industries
- Public-sector users, such as parks, hospitals, and schools.

Clear Guidelines

Pricing systems need clear guidelines about types of costs that can be included in the rate base and how costs should be allocated to different classes of customers. When reviewing costs consider also:

- Who should bear costs incurred for facilities not yet generating productive capacity?
- Should planning costs, such as costs for master plans, feasibility studies, and environmental studies, be included in the price?
- How should interest and debt issuance costs be allocated to different classes of customers, especially present versus future customers?
- What depreciation rules should apply? Should they be the same as those for tax purposes?
- What rules should be written regarding the allowable return (or profit), and how it is to be calculated?

Transparency

Fees and charges, the information on which they are based, and the process by which they are decided should be open to the public. This is necessary for participation by affected parties to be productive.

What Steps Must Local Government Take To Raise Revenues?

- Set clear strategies on how revenue-generating and non-revenue-generating entities should be allowed to set prices
- Increase the capacity of human capital of the service organizations to better manage, operate, and develop the services they provide
- Develop good project proposals to attract finance
- Implement good pricing systems that are transparent and inclusive of the community

Handout: **Evaluating Revenue-Generating Options**

You are to prepare a presentation for the group regarding a capital investment or infrastructure improvement project in your country, following the instructions below.

Instructions

Working as a group:

1. Identify a capital investment project that is critical for attracting private investment.

2. Develop a financial strategy that will address the problem. Consider the following issues:

   - The revenue-generating authority local governments should have to address the problem

   - The types of taxes, fees, and tariffs that are most appropriate for the public service and capital improvements

   - Citizens' ability to pay

   - The collection rate at the local government level.

3. Describe changes that would be needed to allow the implementation of the strategy in your local government.

Use a flip chart to outline your strategy. You have 45 minutes to complete this exercise and will be asked to report on your strategy at that time.